Minutes[*]

Senate Committee on Finance and Planning
Tuesday, February 6, 1996
3:15 - 5:00
Room 238 Morrill Hall

Present: Fred Morrison (chair), David Berg, Thora Cartlidge, Joanne Jackson, Kathy James, Karen Karni, David Kittelson, Gerald Klement, Roger Paschke, Peter Robinson, Doris Rubenstein, Charles Speaks, Craig Swan, Steven Thelen, James VanAlstine

Regrets: Craig Dexheimer, Patrice Morrow

Absent: Allen Goldman, Richard Pfutzenreuter

Guests: Associate Vice President Robert Kvavik

[In these minutes: The financial and other implications of the transaction with Fairview; funding for a capital campaign; academic planning]

1. Fairview and the Hospital

Professor Morrison gaveled the meeting to order at 3:15 and welcomed Senior Vice President Jackson to discuss the Memorandum of Understanding (hereinafter MOU) with Fairview.

Ms. Jackson distributed a handout to the Committee, one she said was used with the legislature to respond to questions. She noted first the admissions statistics for the Hospital, which show a drop of over 8% from the six years 1988-94--a significantly greater drop than the statewide or metropolitan averages. This reflects the impact of managed care: patient days are dropping. The patient census at the University Hospital in December, 1995, was 277; the Hospital capacity is 719. It is for this reason the Hospital is losing $4-6 million per year: there are fewer patients and they are staying fewer days.

A point that was made emphatically with the legislature is that the University has explored many alternatives, including the Mayo Clinic and Allina, among others. Other health care organizations are not interested in affiliation with a public entity, which are in more financial difficulties (Hennepin County Medical Center has similar problems). The private organizations are doing better because they are consolidating and selling ancillary services; they do not make money from patients in the hospital, but obtain access to patients who buy other services.

Moody's Investor Services is insistent that hospitals MUST lower costs; that is the most important thing they can do. Ms. Jackson reported that she had met with the Moody people about the University Hospital and the merger with Fairview; their concern about a public-private partnership is if the private organization can remain profitable when attached to an academic medical center. The perception is that the academic medical centers are very inefficient and that the University will pull Fairview down. She

[*] These minutes reflect discussion and debate at a meeting of a committee of the University of Minnesota Senate or Twin Cities Campus Assembly; none of the comments, conclusions, or actions reported in these minutes represent the views of, nor are they binding on, the Senate or Assembly, the Administration, or the Board of Regents.

said she was insistent there are advantages for Fairview. One is that Fairview lacks expertise in tertiary care, while the University obtains access to primary care patients.

There have been discussions with the state about pensions for Hospital employees, if the employees move to Fairview (which they will IF the deal is consummated). This issue needs to be addressed, because the Hospital has had a $4.6 million loss in the first six months of the current fiscal year, and there will be layoffs--which will NOT be unrelated to the merger and NOT an attempt to "get a jump" on the merger.

Asked what happened when the Hospital lost money in previous years, Ms. Jackson said it laid off 200-300 people. Before 1993, interest earnings from the reserves helped. After that, the Hospital started to curtail operations and laid people off. Those actions helped it get back to the break-even point, but that was also because the Hospital recaptured some Medicare claims from previous years. In 1995, however, without those recaptures and with expenses constant, the Hospital again began losing money. It will continue to do so, so additional curtailment must take place.

One Committee member asked about the $200 million reserve; Ms. Jackson affirmed that it is the income from those reserves that cushioned the losses in earlier years. After--if--the transaction with Fairview is completed, those reserves become available for general University use. They are now being used to support the University's debt capacity, so the Hospital could not spend the money (and needed the earnings itself). When the reserves come back to the University, it might reconsider its debt service limits (e.g., with respect to the steam plant and other building debt service). One possibility is that the University may not have to issue $100 million in bonds for the steam plant.

It is not possible or prudent for Fairview to take over the long-term debt of the Hospital; Fairview would pay more or the University would pay more. Instead, they are taking on their own debt and the University is receiving cash. This is desirable, Professor Morrison commented; the University keeps the debt but receives cash, on which it can make more money than it must pay out. Ms. Jackson concurred.

The concern that the academic health center might bring down the private organization is not without foundation, observed one Committee member. How is the case being made? Ms. Jackson recalled that the MOU outlines the advantage of teaching and research in the Hospital. A committee has been set up that will have responsibility for ensuring there is the right balance between patient care and teaching and research; benchmarks will be set up and efficiencies controlled so that there is no decline in the quality of teaching but also a maintenance of the needed efficiency in serving patients.

Students should be involved in the discussions, it was said, to be sure the quality of instruction is upheld. Ms. Jackson said she did not know how that was being done; she said faculty are involved, and assumes that students will be.

In the Hospital operating statement of expenses, noted one Committee member, there is a regular transfer to the Medical School of about $20 million per year for education and research; will that cease after the merger? It will not, Ms. Jackson said; Fairview is committed to continuing that support. It will not be a cash transfer, but there is a detailed list of things they will pay for in the Medical School, such as partial salaries, labs, and so on. Dean Cerra is reviewing this item of the MOU, but the support will continue. Fairview will not provide a lump sum of cash because it is concerned the money might be used for purposes other than the Medical School. The transfer was made in the past because it is assumed a high-quality medical school is an advantage for a hospital, and that any inefficiencies caused by teaching are offset by the quality of the physicians and the ability to attract patients.

If those funds were to dry up, it was pointed out, the University would have to pick up the expenses. The Committee is being told that some people may receive their salaries from two sources and the University will not have to pick them up. That is correct, Ms. Jackson affirmed. If Fairview were not to continue the support, the University would have to make a choice whether to stay in the relationship or not. It might stay in, because the University receives a distribution of the profits, and in 15 years those may be sufficient to make the relationship more attractive.

The Committee has been told that the Medical School receives $35 million per year from the practice groups. The practice groups will continue and hope they have patients. They want the flow of patients to continue, Ms. Jackson affirmed; they have seen a declining number of patients, so that source of funding is in danger. The money to the Medical School from the practice groups would presumably be the first money cut, said one Committee member. Ms. Jackson said that was not so; salary reductions have already been taken by the faculty so that the money could continue to go to the Medical School. The average physician's salary at the University dropped by $15,000 per year; in terms of average compensation for physicians in Minneapolis, the drop was dramatic.

The issues involved in this transaction are serious, conceded one Committee member, and people involved in it are working hard; without being hostile, can one inquire if all are working so hard to make the arrangement work that they are ignoring the risks? Is Ms. Jackson reassured that urgency of the transaction is not blinding people to the risks?

She said there are several safeguards in place. As the transaction is brought to the Board of Regents, a fairness opinion will be needed: has the University properly assessed the transaction? She assured the Committee that teams from the Academic Health Center as well as from across the University are working on the transaction to ensure a balance of views. If problems are not anticipated now, those who will suffer the most are University employees who do NOT become Fairview employees; if anything goes wrong, it is they who will feel the impact.

The University has received four proposals from banking groups for the fairness opinion, Ms. Jackson said in response to a query, and one of them will be selected to do a financial evaluation. Further, she said, the groups that know the University best are the outside ratings services. At the last Regents' meeting Moody's, which knows the University's books, said the Hospital is the greatest risk to the University; they are very favorable toward the transaction.

One concern is that the fairness opinion will be primarily on the financial side, said one Committee member. He recalled that he has been asked to sometimes do a "cold read" on a transaction: he is asked to give an opinion and raise questions without ever having been involved in the transaction before. Someone on the academic side, from another academic health center, needs to do a "cold read" and asked if an appropriate academic setting will be preserved or if anything has been missed.

Ms. Jackson agreed that this was a good suggestion. She also noted that Regents Reagan and Keffeler had planned public hearings, but it has been suggested that there be public discussions instead, in order to get other opinions about what is taking place. There is a concern that people at the University are too close to the transaction.

Among the top 20-30 peers of the University, how many do not have a Medical School, asked one Committee member? Of those that do have one, how are they addressing these problems? Ms. Jackson said she did not know how many have Medical Schools, but said she did know how they are addressing the problems: they either go much more deeply into the hospital business, by combining with others, or they are getting out of the business. Hospitals of the size of the University's are not viable because they do not have the patient access, so must either become part of a larger business or turned over to one.

Another Committee member said less than a quarter of the University's peers do not have a Medical School, and of those that do, a lot are following a path similar to what the University is doing. The University's problem is even more difficult because managed care is farther along in the Twin Cities than elsewhere.

What if the University had no Medical School and relied on Mayo, it was then asked? Ms. Jackson said Mayo is not a teaching institution; it graduates only about 30 people per year. It is a research and patient-care institution that draws nationally and internationally. With that scope, it might not have any problems developing a Medical School, observed one Committee member. Ms. Jackson said Mayo is very reluctant to do so, if its attitude about being in partnership with the University is any indication. Private institutions are showing an inclination to offer training but in ways that benefits them; they do nothing like the rural physician's program.

One Committee member related discussions that have been held with the 3500 Hospital employees who are not represented by a bargaining agent; when will those employees be brought into the discussions? There is a concern that in the rush, they will be ignored. Ms. Jackson said Associate Vice President Carrier has assured all employee groups she will meet with them to discuss the negotiations. Those discussions were to start this week, although people have had to spend a lot of time at the Capitol answering questions.

One Committee member noted that University Hospital patients are VERY ill. As the number of people who deliver care--doctors, nurses, lab staff--decline, what will be done to ensure the quality of care? Quality measures are part of what is being looked at; they are trying to establish outcome measures to ensure quality, Ms. Jackson said. Although it is a managed care environment, there is still latitude in patient care. If the organization does not keep up the quality of care, it will not retain its contract for managed care.

If the University does not want to continue the relationship in the future, what language allows it to pull out--what would the grounds be? Work on that has just started, Ms. Jackson replied; ideas from the Board of Regents will be sought this week. The language related to the building and land will probably be relatively easy to develop; it will be treated as a lease, and the facilities would be returned so the University would have the opportunity to seek a different alliance. More difficult is what the notice provision should be and what the benchmarks will be. They want to be sure that if the University wants to get out of the relationship, it can move the program elsewhere.

One Committee member inquired what impact the Duluth Medical School will have on the balance sheet; Mr. Paschke replied that it is not treated like a business, but rather as an academic unit and that it has no impact on the balance sheet. One Committee member said it is an academic program that sends students to the Twin Cities; it has no relationship with the Hospital. If it were closed, said another Committee member, the expenditures on it (about $20 million per year) would evaporate. If the Twin Cities Medical School is reducing class size, is it still rational to keep the Duluth Medical School--when there clearly is capacity on the Twin Cities campus? One must always take into account political considerations, but there is a hard question that needs to be looked at.

Ms. Jackson agreed, but pointed out that the Duluth Medical School represents a state commitment to the education of rural physicians--and it has been very successful at it. Would the University be able to keep that commitment with the Twin Cities program? They are considering a different approach that might combine the programs but still allow the Duluth program to continue. She told the Committee she would talk with Provost Brody about this issue.

One concern is that as class size and the residency population decreases, the per-student costs will increase, as will the subsidy, which is already large. Should the University seek ways to control that cost?

Another Committee member inquired why class size had to fall; with health care costs inflating, the best way to cut them is to overproduce doctors. They are in a monopoly position now, which keeps salaries artificially high. It is time to rethink the decision to reduce the class sizes in the Medical School. There would be no problem filling slots if admissions were to be increased, and there would be additional tuition revenue as well.

Ms. Jackson said she was not an expert on the subject, but could relate what she has heard: if the University wants to be customer-responsive (to its students), graduates are finding it more difficult to obtain positions in specialties. The demand is not there, and physician income is coming down. In some specialties, there are no jobs. Should the University offer training when it knows there are no jobs?

That is a comment on the Medical School; what about patients; one can be sensitive to both. The normal laws of economics seem not to work, observed one Committee member; as supply increases, cost increases.

The Committee should talk with Dean Cerra, Professor Morrison concluded, and he thanked Ms. Jackson for the discussion.

2. Funding a Capital Campaign

Professor Morrison turned next to Mr. Paschke for a discussion of the funding of a possible capital campaign.

Mr. Paschke distributed copies of a letter to the Board of Regents about charges against the endowment funds that will be discussed this week. No proposal has been made; the consultation process has only begun so this discussion is very timely.

The University of Minnesota Foundation has an endowment under the control of its trustees; its value is about $350 million and the income supports a variety of University activities. All new funds for the endowment go to the Foundation. The Board of Regents also has about $400 million in endowments, money that has come in without a lot of fund-raising activity over the life of the institution.

There are, thus, two separate endowments with two separate owners, but all the money goes for the same purposes and is managed in much the same way.

The Foundation has been levying a charge on its endowment (.75% annually, or 75 basis points) to fund its activities, and has been planning another capital campaign (although it has not been announced). The question is how the Foundation will fund the campaign. The letter to the Regents raises the possibility of applying the .75% charge to the Board of Regents endowment as well as a way of funding a campaign. At present the Regents' endowment is charged only for the investment management fees (about .34%) and other actual expenses; this would add the .75%.

Adding the 75 basis points to the charge would affect the return and would have an impact on departments. The University's spending policy--what is distributed to departments--is 5.5% of the three-year rolling average market value of the fund. That rate has been consistent and does not change annually. Since the endowment has been growing rapidly due to investment performance, the actual rate that departments receive annually is 5.25%. The problem is that if one looks out the next ten years, Mr. Paschke explained, it is unlikely that the investment return on the endowment will be as high as the last five or ten years. The endowments have been earning more than expected; he projects the return will be about 10% over the next ten years. Given that assumption, if one takes off 5.25% distributions to departments, the total investment expenses (estimated at .67 to .75%), and inflation, and then add 75 basis points for a campaign, the projection is for "negative growth" in the endowment. That cannot be allowed to happen, Mr. Paschke told the Committee, so there is a linkage between the campaign funding and the money distributed to departments. The spending rate should probably be reduced some even without the administrative charge. With the .75% charge, a spending rate reduction seems required.

One Committee member, noting the University expenses projected at 67 to 75 basis points, inquired what those expenses are at the Foundation. Mr. Paschke said they are also expected to be about 67 basis points in the future.

Applying 75 basis points to the $400 million Board of Regents endowment leads one to conclude it would produce about $3 million annually for a campaign, one Committee member calculated. Mr. Paschke said the charge would not be applied to the Permanent University Fund, which is public funds; those total about $160 million. The charge would apply to the remainder of the endowment ($200 million).

If the 5.5% annual spending rate is cut, to avoid "negative growth" in the endowment, the cut would be across the board for all units that have money in the endowment, one Committee member pointed out. At the same time, the money used for the campaign would not necessarily raise money for all units that have money in the endowment. Mr. Paschke agreed, there would be no direct linkage between funds raised and those who benefit, but that the University as a whole would clearly benefit. He also agreed that if the spending rate on the Regents' endowment were reduced, he would recommend that the Foundation do so as well.

What would be the impact on donors, asked one Committee member, if they realize that fewer dollars are going to where they wish? Both he and the Foundation share that concern, Mr. Paschke commented, as well as a concern about unit budgets.

How was the Minnesota Campaign (under President Keller) financed, asked one Committee member? And how does this proposal compare with how other universities finance capital campaigns? Mr. Paschke said the central reserves were used to fund the Minnesota Campaign, and cost about $5 million. Other universities do it different ways; by charges such as the one being considered here, or a charge on gifts, or by warehousing the gifts and using the first-year income to fund the campaign expenses. The question, he said, is what is the best formula for this university to use.

Is there cost-benefit analysis one could do? Does it cost more to get the money than the benefit gained? There is clearly more money raised than spent to raise it, Mr. Paschke said; one can put in $1.5 million annually and expect to raise hundreds of millions of dollars over time.

One Committee member reported that after such campaigns, there is a residual effect; because of pledges made and new donors, giving levels do increase over the levels before the campaign. Inflation, however, may consume some of the increased funds.

The implication is that the charge against the endowment would last as long as the campaign, or would it be permanent? It would not be the intention to make it permanent, Mr. Paschke said. For the charge to be imposed, the Board of Regents would have to authorize it; the administration cannot do it unilaterally. He would recommend that it end with the end of the campaign. If it were begun in the next two years, it would last about five years, so would end in 2002 or 2003.

Mr. Paschke confirmed, in response to a question, that the charge would not apply to the Minnesota Medical Foundation specifically because he thought they already had a similar charge.

One Committee member expressed a concern about fiduciary responsibility for the endowments (for example, for funds used to aid students from Goodhue County). One cannot understand how those funds could be charged in order to raise money for research and for other students from other counties. There is a question about the fiduciary responsibility of the Board of Regents and their obligation to respect the uses for which the money was donated.

A second concern, it was said, is about the University putting surplus earnings (above inflation) bad into the endowments in recent years and the need for a positive return. Those surplus earnings could offset some of the negative returns in the near future. There is no fiduciary responsibility to keep the return positive every year.

Mr. Paschke agreed with the latter point; that is the way the endowment works. There have been negative years, but the spending rate did not change. If long-term return to the endowment were projected at 8%, he would make a recommendation to further lower the rate. But he expects returns to be about average. The gains from income in recent years have been banked to support the spending levels, but this is a new factor.

The Committee member agreed, but recalled that the rate of return on the endowment had been 18% when inflation was 6%; that created a lot of surplus return, which could cushion the endowment for a few years of one-half percent negative return.

To cut one-half percent from $200 million of the endowment amounts to a $1 million retrenchment imposed in order to keep a positive growth in the value of the endowment--when there was extra growth in the endowment over the last ten years.

Another Committee member objected again to the proposition that the University would take money from one donor to try to raise money from another donor. Mr. Paschke agreed that this is a debatable point but it is legally acceptable, and it is a reason to have this conversation about the campaign.

Those who benefit should pay, said one Committee member; there could be a loan to the Foundation, repaid from a charge against initial earnings on the money raised. And there is an issue of the spending rate; the University has been able to support a spending rate of 5.5% and increase the real value of endowments because investment returns have been extraordinarily high in recent years. Longer-term evidence suggests that the spending level should come down to protect endowments against inflation in the future. If the spending is adjusted down to 5% or 4.75%--consistent with what other institutions do--it should be done so in an orderly way over several years, perhaps 10 basis points a year, and it should be clear that all excess income will be reinvested in the endowments.

Agreed, said another Committee member. It would be useful to set up annual distributions, because departments budget annually.

One Committee member recalled asking the Foundation for assistance in a departmental fund-raising effort, and was told that it was inappropriate to use donations in this way; the department was told it had to pay for the fund-raising. It did so, and the same ethics should apply in this case, it was argued.

Mr. Paschke was complimented by one Committee member on the balance of his presentation. The idea of the campaign has a small group of fans at the Foundation, it was said, who are pushing it far beyond what is the realistic capacity to raise the money, in the views of some. This issue raises another cautionary note.

One Committee member said that the majority of funds in the endowment are dedicated to helping students; to the extent it is not being put in financial aid but in buildings and other activities, the purpose has already been changed. Mr. Paschke responded that the uses of the money are restricted by donor intention and that is the way it is used by the University.

A concern about financial aid is that tuition is increasing faster than inflation so the value of financial aid dollars is declining, Associate Vice President Kvavik commented. If a new campaign adds money to scholarship funds, he said he would like to see the money invested in the campaign to increase those funds, because the University does not have the money to support the recruiting goals it has set for itself.

Professor Morrison thanked Mr. Paschke for his presentation.

3. Planning

Professor Morrison next welcomed Associate Vice President Kvavik to the meeting to discuss academic planning.

The Committee has been sent copies of the planning documents, Dr. Kvavik recalled. They have also been sent to the provosts, he said, but he does not know what the provosts are doing with them. He said he also does not know the extent to which the provosts have put planning parameters on the units; the central planning document made it possible for them to do so. The information that will be obtained from the planning documents will probably be more important for the biennial request; it will have little impact on the 1996-97 budget.

Will this become a biennial exercise, asked one Committee member? That is his recommendation, Dr. Kvavik replied. Will it be this late in the future? It needn't have been as late as it is, Dr. Kvavik said; the planning office had the documents ready some time ago, but had to wait on financial parameters. The last time there were no such constraints; in hindsight, that was a mistake, because they received planning documents that could not be implemented because the funds were not available. This time, it was felt, there should be fiscal constraints. He said he would not disagree with those who say the constraints were not sufficient. There is a timing problem, he agreed, and the documents should not come this late, but that is part of the growing process in planning.

His sense, said one Committee member, is that the biennial request development will be quite far along by the time the planning documents are prepared; they will have an effect on refinements of the request, but not on its substance, so there was a missed opportunity for the next two years. One hopes the process can be pushed back, so that the documents are due in the fall of 1997, not the spring of 1998.

Dr. Kvavik said he has spoken with the provosts; the Office of Planning and Analysis (OPA) is responsible for the format of the documents and for gathering information about institutional goals; he said he hopes the provosts use the same method so there are not multiple planning documents. He also hopes the provosts will not build up their own planning structure and that OPA could provide useful services they need.

That is very important, said one Committee member. The dean must respond to the provost and generate excitement and plans; it is critical these be the same as the provosts' or there will be mixed messages and unnecessary work. Dr. Kvavik said he feels strongly that OPA should provide information useful to the provosts--or OPA should be broken apart and the money put where it would be more useful.

There is never supposed to be closure in planning, observed one Committee member. It is supposed to be a rolling process, Dr. Kvavik agreed. But, it was then said, one hears that there is never any response to the plans except that the document is complete. The provosts must say that these are the parameters, that units can do this and cannot do that; if they do not, this is a hollow exercise of filling out forms.

Dr. Kvavik agreed. The problem with the first round was they received plans from all units but the planning office was not staffed to respond to them in a timely manner. They did send an assessment of the documents, and then the new provostal structure was established, so the planning office asked if it should be making academic judgments, when Academic Affairs was not responsible for the units any longer. The documents were given to the provosts, and included comments that the provosts could use with the deans.

The protocol they are using is that of asking questions for which answers are needed for institutional planning--for issues such as enrollment, facilities, differentiation of mission, and so on. They also include in the documents signals about external factors to which they believe units should pay attention. The documents are designed so the provosts can raise specific questions about their units, and they need to be sure that their parameters guide planning, in additional to central parameters, so the units respond to provostal concerns. OPA will respond to institutional concerns. This division of labor will take time to work out, Dr. Kvavik commented, and working with the provosts' offices to make it reality.

What about the coordinate campuses, asked one Committee member? The same approach is being taken, Dr. Kvavik replied. The capacities of the campuses differ; OPA has tried to adjust its services accordingly. They provide staff to the campuses who have the needed expertise--but they are to help the chancellors, not create a central plan for the campuses.

Is that a model for working with the provosts, it was asked? That is what they are trying to accomplish, Dr. Kvavik said. The provost must have a contact person to receive requests, and they will be asked if they received what they wanted so that OPA can assess the quality of its work. OPA has written a mission statement, so it knows its tasks and how it relates to the President, the provosts, and the deans, and identified where it can serve and where it cannot.

One concern is balkanization, said one Committee member: if there is no institutional planning, the provosts will do it because they do not like OPA's plans. That will be a nightmare. What is the relationship between his office and the provosts? Does it rely on good will?

OPA is doing the INSTITUTIONAL plan, Dr. Kvavik said; they are not including the future of the biological sciences or developmental education, or the balance between research and outreach in a particular unit. That is the role of the provosts; OPA will incorporate their recommendations into the institutional plan. What about tenuring faculty on soft funds? The University has been doing that for a long time, Dr. Kvavik replied. There should be a financial plan, and they will look to the Office of Budget and Finance to help in that area.

There is no financial plan spelled out except parameters about utilities, tuition, inflation, and so on, said one Committee member. There are a lot of other factors that should be included in a financial plan. Has anyone done anything about this?

Dr. Kvavik said it is not included in the plans now. When they started the planning process, they believed there should be an academic plan that drove the financial plan. There has been one round of planning. There is also an evaluation piece, the critical measures. It is supposed to be that the academic plan drives the financial plan and there are outcomes and then adjustments. In some areas that is happening; goals have been set for undergraduate education (e.g., 80% of new freshmen should come from the top quartile of their class). When enrollment fell below the goals, money was put into financial aid, and enrollment is now back on target--and applicant quality is higher than last year. There have been plans, assessment, and action, and a realization that units can continue to reach goals. This must also be done in research, University College, user-friendliness, and a lot of other areas as well. In some areas, however, the protocol is beginning to work, he concluded.

Professor Morrison asked if there were additional questions; hearing none, he adjourned the meeting at 5:00.

-- Gary Engstrand

University of Minnesota